ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Sen. Rev. & Tax. Comm. Analyst: Jeani Brent Bill Number: SB 2234

Related Bills: See Legislative History Telephone: 845-3410 Amended Date 04/13/98

Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: AB 3086 Cleanup/LLC Suspension Technical/Nonresident Alimony Deduction/ Excess SDI/Federal Adjustments/Commercial Domicile Restriction

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED March 3, 1998, STILL APPLIES.

X OTHER - See comments below.

SUMMARY OF BILL

This bill, sponsored by the Franchise Tax Board, would make the following changes:

1. Clarify the Unemployment Insurance Code (UIC) requirement amended by AB 3086 (Stats. 1994, Ch. 1049) regarding which amounts must be included in the Report of Wages by specifically including amounts withheld from pensions, annuities, and other forms of deferred compensation.

2. Clarify that the department may suspend any limited liability company (LLC) not classified as a corporation for California tax purposes. This bill also would make nonsubstantive technical changes.

3. Provide that nonresidents prorate the deduction for alimony payments in the same manner as the nonresident tax is prorated.

4. Retain the program to refund excess state disability insurance through the tax return while ensuring that taxpayers who fail to claim the credit on their return still would be identified as quickly as possible to receive a refund of their excess contributions.

5. Make several changes relating to federal adjustments regarding defining the final federal determination date and requirements for taxpayers to notify the department of any federal changes to their tax return.

6. Remove the commercial domicile restriction, thereby permitting all corporations, regardless of commercial domicile, to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax.

Board Position:			Department Director	Date
X S	___ NA	___ NP		
___ SA	___ O	___ NAR		
___ N	___ OUA	___ PENDING	Gerald H. Goldberg	6/11/98

SUMMARY OF AMENDMENT

The April 13, 1998, amendments added the provisions identified as numbers three through six above, which will be discussed separately in this analysis. The discussion of items one and two above in the department's analysis of the bill as introduced still applies.

REVENUE ESTIMATE

Based on data and assumptions discussed below, revenue losses from this bill are estimated to be as follows:

Estimated Revenue Impact of SB 2234 As Amended April 13, 1998 (In $Millions)				
		1998/99	1999/00	2000/01
1.	Nonresident Alimony Deduction	($5)	($2)	($2)
2.	Corrected Tax Return / Fed. Determinations	(*)	(*)	(*)
3.	LLC Suspension	(*)	(*)	(*)
4.	Unemployment Insurance	(*)	(*)	(*)
5.	LLC / Definitions	(*)	(*)	(*)
6.	Insurance Company Dividends Deduction	(**)	(**)	(**)

Note: (*) No revenue effect
(**) Unknown losses

BOARD POSITION

Support.

The Franchise Tax Board voted at its November 17, 1997, meeting to sponsor the language in this bill identified as issue #1, relating to AB 3086 cleanup, and issue #2, relating to LLC technical clean-up.

The Franchise Tax Board voted at its March 26, 1998, meeting to sponsor the language in this bill identified as issue #3, relating to the deduction for nonresident alimony payments, and issue #4, relating to excess state disability insurance refunds.

The Franchise Tax Board voted at its February 4, 1998, meeting to sponsor the language in this bill identified as issue #5, relating to federal adjustments.

The Franchise Tax Board voted at its January 12, 1998, meeting to sponsor the language in this bill identified as issue #6, relating to the removal of the commercial domicile restriction.

ISSUE #3: Nonresident Alimony

EFFECTIVE DATE

This bill provides language that would apply the nonresident alimony deduction changes to all taxable years in which the statute of limitations for issuing proposed assessments or allowing claims for refund remains open. The purpose of the retroactive application is to avoid potential disputes with taxpayers over the enforcement of an unconstitutional statute.

SPECIFIC FINDINGS

Federal Constitution

The United States Constitution, under what is known as the Privileges and Immunities Clause, provides that the citizens of each state shall be entitled to all the privileges and immunities of the citizens of the several states. The United States Supreme Court has interpreted this clause, as it applies to taxes, as follows:

> "...One right thereby secured is the right of a citizen of any State to remove to and carry on business in another without being subjected in property or person to taxes more onerous than the citizens of the latter State are subjected to."[1]

In *Lunding*, the Supreme Court struck down a New York statute which denied nonresidents an alimony deduction in computing New York adjusted gross income. The court held that New York's categorical denial of the deduction to nonresidents violated the Privilege and Immunities clause of the Federal Constitution,[2] stating that New York had not substantially justified its discriminatory treatment of nonresidents. In striking down the New York statute, the Court accepted the petitioners' determination that the deduction should be allowed in the same ratio that their business income was attributable to New York sources.[3]

State Law

The existing California Personal Income Tax Law (PITL) imposes tax on the basis of residency and source. Residents and part-year residents (while they are residents) are taxed on all income earned, regardless of source. Nonresidents and part-year residents (while they are nonresidents) are taxed only on income from sources within California.

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[1] *Lunding Et Ux. V. New York Appeals Tribunal et al.* , ____ U.S. ____ (1998), (Docket No. 96-1462) (citations and internal quotation marks omitted).

[2] Although New York's nonresident alimony statute New York Tax Law Section 631(b)(6) is worded differently than California's Revenue and Taxation Code Section 17302, the effect is identical.

[3] It is unclear whether in *Lunding*, the petitioner computed his deduction by applying the ratio of New York to total business income or adjusted gross income, or if, in his situation, the ratio was the same. From a constitutional standpoint, however, it makes little difference exactly how the deduction is prorated so long as the method can be substantially justified and does not result in a categorical denial of the deduction to nonresidents.

Existing law imposes an income tax on the income of nonresidents that is derived from or attributable to sources within this state. "Income from sources within this state" is defined by regulation as income from tangible or intangible property located or having a situs in this state and income from any activity carried on in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce. The law provides six personal income tax rate brackets ranging from 1% to 9.3%.

Existing law requires nonresident taxpayers to include income from all sources to determine the rate at which California tax is imposed on their California source income. The total taxable income is computed as if the nonresident were a resident for the entire year. The amount of tax that would be imposed on the total income is prorated based upon the ratio of California-sourced adjusted gross income to total adjusted gross income from all sources to determine the tax imposed on the California-sourced taxable income. The California tax before personal exemption is the tax that bears the same ratio to total tax, as California source adjusted gross income bears to total adjusted gross income. This method effectively results in the nonresident or part-year resident computing their tax at the same graduated tax brackets as used for computing the tax of a resident.

In determining California-sourced income, **existing law** does not allow a deduction for alimony payments made by a nonresident or a part-year resident (while a nonresident) even if to a California resident. This provision denying a deduction was first introduced in 1957. The justification appears to have been that California does not tax nonresident taxpayers on alimony income and, thus, should not allow nonresidents an alimony deduction.

California's categorical denial of an alimony deduction to nonresidents is unique in that business and investment expenses are allowed as deductions in computing California adjusted gross income if the expenses are attributable to the production of California source income. Itemized deductions are, in effect, allowed in the ratio that California adjusted gross income bears to total adjusted gross income because the California method requires that tax on total taxable income (which includes total itemized deductions) be prorated by the ratio of California adjusted gross income to total adjusted gross income.

The effect of **existing state law** is identical to the New York statute, and there appear to be no arguments that could reasonably be advanced to support its application that were not presented and rejected by the Court in *Lunding*. Thus, it appears that the existing state law that denies the alimony deduction to nonresidents facially violates the Privilege and Immunities Clause of the Federal Constitution.

The California Constitution prohibits an administrative agency from refusing to enforce a California statute on the grounds that it is unconstitutional unless declared to be unconstitutional by an appellant court.

This bill would provide that nonresidents prorate the deduction for alimony payments in the same manner as the tax is prorated. This ratio would compare California-sourced adjusted gross income (without regard to the alimony deduction) to total adjusted gross income from all sources (without regard to the alimony deduction).

This bill also would provide that a part-year resident would be allowed an alimony deduction for the full amount paid during the portion of the year the individual is a resident and a prorated amount for the portion of the year the individual is a nonresident.

Policy Considerations

The California Constitution does not permit the Franchise Tax Board to take any action that could be construed as a refusal to enforce the existing law that denies the nonresident alimony deduction.[4] While the "refuse to enforce" phrase of Article 3, Section 3.5 is nowhere defined, it certainly precludes the Franchise Tax Board from allowing claims for refund based upon application of the methodology the Court embraced in *Lunding*.

This bill coupled with the retroactive operative date would relieve the Franchise Tax Board of defending Revenue and Taxation Code Section 17302 in administrative and judicial proceedings and thus avoids the expenditure of resources in disputes when the probable outcome would be that Section 17302 would be declared by an appellate court to be unconstitutional.

The amendment would avoid discrimination against nonresident taxpayers who currently are denied an alimony deduction.

By allowing a pro-rata deduction for alimony, California would place alimony on a par with other deductions that are allowed to offset either directly or indirectly California source income and gives recognition that the amount of alimony paid generally correlates with a taxpayer's total income or wealth and, thus, bears some relationship to earnings regardless of their source.

Implementation Considerations

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update. The department would receive additional amended returns for the years for which the statute of limitations is open, but this workload is not expected to be significant.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

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[4] In *Appeal of Stephen C. Eldridge*, the Board of Equalization held, in a decision not to be cited as precedent, that it could not refuse to enforce Section 17302 on constitutional grounds referring to the prohibition imposed on administrative agencies by Article 3, Section 3.5. In that case, a New York resident argued that Section 17302 violated the Privileges and Immunities clause of the Federal Constitution and provided a New York Supreme Court decision holding that New York's alimony statute was unconstitutional, *Matter of Lance J. Friedsam v. State Tax Comm.*, (N.Y. Sup. Ct., App. Div., 3d Dept., No. 44145 December 15, 1983.)

Tax Revenue Estimate

This provision is estimated to impact PIT revenues as shown in the following table.

Retroactive to Open Years Enactment Assumed After June 30, 1998 $ Millions		
1998-9	1999-00	2000-01
($5)	($2)	($2)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

This estimate was calculated from a microsimulation analysis of nonresident returns on which an alimony deduction was claimed. The tax liability of each return was recalculated using the proposed method of accounting for alimony payments. This proposal would allow taxpayers to file amended returns for all open years (back to 1994). For this estimate, it is assumed that the probability of filing an amended return would be about 10% for the 1994 tax year and that the probability would increase incrementally to 50% for 1997. It is assumed that for tax years 1998 and beyond, taxpayers would be in full compliance.

ISSUE #4: Excess State Disability Insurance Refunds

EFFECTIVE DATE

This provision would take effect January 1, 1999, and would apply to returns for the 1998 taxable year filed in 1999. It is expected that the improved method for crediting refunds would be implemented for the 1999 taxable year processed in 2000.

PROGRAM HISTORY/BACKGROUND

The State Disability Insurance Fund, created under the Unemployment Insurance Code, is funded by contributions withheld from the first $31,767 in wages paid to each covered employee in California. Employers are required to withhold the disability insurance contributions from the wages of each employee up to the taxable wage limits and remit the funds to the Employment Development Department (EDD) quarterly. The tax rate and maximum withholdings due from an employee was $412.97 for 1993 and 1994 (1.3% of $31,767), $317.67 per year for taxable years 1995 and 1996 (1% of $31,767) and $158.84 for 1997 (.5% of 31,767). However, if a taxpayer has more than one employer and earns more than $31,767 during a year, the taxpayer’s employers could jointly withhold more than the maximum required. The taxpayer is entitled to a refund of the excess amount.

Taxpayers may claim a refund of excess state disability insurance payments on their state income tax return. Prior to 1995, income tax form instructions did not specifically notify 540A and 540EZ filers that a credit was available for excess state disability insurance and that they must file Form 540 to claim a refund of excess state disability insurance. For tax year 1995, 540A and 540EZ tax booklets informed taxpayers that they must file Form 540 to claim the credit. For tax year 1996 and after, Form 540A allows taxpayers to claim the excess state disability insurance credit, while the Form 540EZ provides instructions informing taxpayers that they may file a Form 540, 540A or 540NR to claim the excess state disability insurance credit.

SB 1682 (Ch. 1157, Stats. 1996) requires the EDD, in conjunction with the Franchise Tax Board (the department), to identify taxpayers who overpaid state disability insurance and issue refunds. According to the author's office at that time, the legislative intent of the bill was to remove from the tax forms all lines requiring taxpayers to claim excess state disability insurance and to create an automatic process whereby taxpayers would receive automatic refunds without filing a claim. The law:

- Required retroactive refunds, with interest from April 15th of the tax year following the overpayment, to be paid by October 15, 1997, for tax years 1993, 1994, and 1995 to taxpayers who filed Forms 540A or 540EZ and did not claim their state disability insurance overpayments; and

- Beginning with the 1996 tax year, required the director of the EDD to identify and refund to taxpayers overpayments of state disability insurance, with interest from January 1 of the tax year following the overpayment at a rate equal to the earnings rate of funds placed in the State Disability Insurance Fund.

Although the Form 540 provided taxpayers an opportunity to claim refunds, the department and the EDD found that a significant number of taxpayers neglected to claim the credit. Therefore, the department and the EDD administratively agreed in November 1996 to identify and refund (without interest) any overpayment of state disability insurance where taxpayers had filed Form 540 or 540NR.

To date, the department, in conjunction with the EDD, has identified and credited more than 396,000 state disability insurance overpayments that had not previously been claimed. Based on time constraints and resource limitations, the department agreed to continue collaborating with the EDD to retroactively process state disability insurance overpayments in the same manner for the 1996 and 1997 tax years, with the understanding that a more efficient long-term processing solution would be explored for future years.

SPECIFIC FINDINGS

The Revenue and Taxation Code provides that any excess state disability insurance contribution shall be credited against income tax and applied to the year the excess contribution occurred. Any overpayment of taxes may be refunded. Denial of the credit may be appealed to EDD.

The Revenue and Taxation Code provides that interest shall be allowed on overpayments of tax at an adjusted rate established in accordance with the rate of interest paid by the Internal Revenue Service on refunds. If any overpayment of tax is refunded or credited within 45 days after the date the return is filed, or within 45 days of the last date for filing the return, whichever is later, no interest will be allowed on the overpayment.

Prior to the enactment of SB 1682, the **Unemployment Insurance Code** did not allow interest to be paid on state disability insurance overpayments. Additionally, taxpayers with two or more employers were required within three years from the last day prescribed for filing a tax return, to claim a refund of state disability insurance overpayments by filing a personal income tax Form 540 for the taxable year in which the overpayment was made. However, as a result of SB 1682, for 1996 and future years, the Director of the EDD is required to identify and refund overpayments of state disability insurance to taxpayers with interest from January 1 of the year following the year of the overpayment at a rate equal to the earnings rate of funds placed in the State Disability Insurance Fund.

The Government Code authorizes an offset claim procedure whereby the Controller may collect money due the state by deducting the amount of the debt from any money that the state may owe the debtor, i.e., state disability insurance or income tax refunds. The department administers this program for the Controller. If a taxpayer owes income tax, any excess state disability insurance will be applied against tax owed or against other amounts owed, as identified by the offset program.

The Unemployment Insurance Code provides for reimbursement of the department's administrative costs for processing tax forms on which taxpayers claim excess state disability insurance.

Currently, taxpayers who have had excess state disability insurance withheld by their employer may receive a refund in two ways: claim the excess state disability insurance credit on a timely filed Form 540 or 540A return, or, for those taxpayers who fail to request credit due to them, receive a refund through a process administered jointly by the EDD and the department to identify and refund amounts due but not claimed on the tax return.

Currently, the **Unemployment Insurance Code** requires, for tax years beginning on or after 1996, that the Director of the EDD identify and refund overpayments, with interest from January 1 of the tax year following the overpayment, to taxpayers who have overpaid state disability insurance contributions but who have not filed for refunds. However, the EDD does not have an automated system in place and does not have all of the information needed to make direct refunds to taxpayers. Thus, the EDD has contracted with the department to process the refunds. However, the interest rate paid, and the date from which interest is calculated, by the State Disability Insurance Fund is different from the interest rate and calculation date for computing interest on income tax refunds. The department would like to implement a system where overpayments of state disability insurance are credited immediately upon receipt of a tax return. However, the current interest rate calculation prevents implementation of this process.

This bill would clarify that payments would not need to be made directly from the State Disability Insurance Fund and that interest would be paid according to the method and rate for overpayments of tax rather than the method and rate applicable to overpayments of amounts creditable to the State Disability Insurance Fund.

Policy Considerations

This bill would retain the program to refund excess state disability insurance through the tax return while ensuring that taxpayers who fail to claim the credit on their return still would be identified as quickly as possible to receive a refund of their excess contributions. Moreover, this bill would allow interest at the same rate and under the same conditions as if a taxpayer had excessive income tax withheld from his or her paycheck. The bill would allow the EDD and the department to continue to work collaboratively to find the most effective and efficient ways to credit excess state disability insurance money that is due to taxpayers.

Implementation Considerations

Department staff is developing plans to implement this provision during the earliest possible taxable year. The provisions regarding interest would be implemented for refunds issued for the 1998 taxable year, which would be processed in 1999. Department staff anticipates that provisions for crediting excess state disability insurance upon receipt of a return would be implemented for returns filed for the 1999 taxable year processed in 2000.

FISCAL IMPACT

Departmental Costs

Departmental costs are difficult to determine until further implementation plans are developed. However, it is anticipated that the department’s costs to implement this proposal would be reimbursed through an agreement with the EDD.

Tax Revenue Estimate

Any refunds directly paid from the Personal Income Tax Fund would be reimbursed by the State Disability Insurance Fund. Thus, this provision would not have any revenue impact under the Personal Income Tax Law or the Bank and Corporation Tax Law.

ISSUE #5: Federal Adjustments

EFFECTIVE DATE

This provision would apply to federal determinations that become final on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 571 (Stats. 1992, Ch. 335), SB 3 (Stats. 1993, Ch. 31), SB 673 (Stats. 1993, Ch. 887).

BACKGROUND

Enactment of SB 571 (Stats. 1992, Ch. 335) created parallel but not duplicate code sections regarding the reporting of federal changes in Section 18451 of the Personal Income Tax Law (PITL) and Section 25432 of the Bank and Corporation Tax Law (B&CTL). PIT taxpayers were required to report only changes or corrections that affected the amount of tax payable (either a refund or assessment) while B&CT taxpayers were required to report all changes (an exemption clause was included in the PITL). Upon the creation of the Administration of the Franchise and Income Tax Laws (AFITL) by SB 3 (Stats. 1993, Ch. 31), these two code sections were combined. The exemption clause found in the prior PITL was modified to require only the reporting of changes that increased the amount of tax payable and was made applicable to all taxpayers. Thus, B&CT taxpayers no longer were required to report all changes.

SPECIFIC FINDINGS

Current state law requires the taxpayer to notify the department if the amount of gross income or deductions reported to the Internal Revenue Service (IRS) for any year is changed, either by the taxpayer or federal authorities. However, a change in the amount of gross income or deductions that does not result in an increase in the amount of California tax payable by the taxpayer is arguably not required to be reported to the department.

The taxpayer can report a change by sending the department a copy of the federal change documents or by filing an amended tax return. If required to be reported, the change must be reported within six months after a “final federal determination” of this change or correction. “Final federal determination” is defined in regulations (Cal. Code of Regs., Title 18, Section 18586.3) as an irrevocable determination or adjustment of a taxpayer’s federal tax liability from which there exists no further right of appeal either administrative or judicial. The regulation lists three examples of different types of final federal determinations:

- A closing agreement pursuant under Internal Revenue Code (IRC) Section 7121.
- The notice of deficiency (IRC Section 6213(a)) or the expiration of the appeal period for the judgment of the court of last resort.
- The assessment of deficiency pursuant to a waiver filed under IRC Section 6213(d).

Changes that must be reported to California when they increase the amount of tax payable include:

- Amendments made on a return filed by the taxpayer with the IRS,
- Results of a revenue agent's examination or other changes or corrections by the IRS,
- Change or correction by any other officer of the U.S. or other competent authority, or
- Renegotiation of a contract or subcontract with the U.S.

If a change is timely reported by the taxpayer, the department has two years from the date the change is reported to assess any additional tax resulting from the change. If a taxpayer does not report the change as required, or fails to file an amended return with the state, the statute of limitations for assessment by the department is suspended and the department may issue an assessment at any time. If the taxpayer advises the department of a change, but does so only after the expiration of the six-month period for reporting, the department has four years from the date the change is reported to issue an assessment with respect to the change.

A change in the amount of gross income or deductions which results in a federal refund of tax is not required to be reported to the department. However, in order for a state refund to be allowed the taxpayer must file a claim for refund resulting from a change within two years from the date of the final federal determination.

Through reciprocity arrangements with the IRS, the department generally receives directly from the IRS copies of examination reports of individuals with California addresses. Department staff reviews the reports and issues applicable assessments, not waiting for notice from the taxpayer. However, the department does not always receive copies of examination reports for bank and corporation taxpayers with business locations in multiple states or with out-of-state addresses.

This bill would make the period to assess additional tax resulting from a federal change the same whether information is received from the taxpayer or the IRS. If the department receives notification from the IRS within six months of the final federal determination, the department would have two years from the date the change is reported to issue an assessment. If the department receives notification from the IRS after the six-month period, the department would have four years from the date the change is reported to issue an assessment.

This bill would define the final federal determination date. The date of final federal determination would be the date on which each adjustment or resolution (assessment, refund or no change) resulting from an IRS examination is assessed pursuant to IRC Section 6203 (commonly known as the 23C date).

This bill would clarify that notification of a change or correction by the taxpayer or IRS must be sufficiently detailed to allow computation of the resulting California tax change. This provision clarifies that the statute of limitations starts when sufficient notice is provided to the department by the taxpayer or the IRS.

This bill would clarify that taxpayers must notify the department of any federal change that increases tax for any year and to require B&CT taxpayers to report all changes or corrections to gross income or deductions, even if the changes or corrections do not result in an increase in tax payable for any year. This bill would not otherwise change the period of time allowed for assessments or refunds.

This bill would clarify that taxpayers, who are required to report federal changes, are required to (1) report each final federal determination, and (2) report changes to any item reportable on the federal income tax return.

This bill would remove an unclear phrase from R&TC Section 19060.

Policy Considerations

When the Franchise Tax Board sponsored SB 571 (Stats. 1992, Ch. 335), it recognized that PIT and B&CT taxpayers should be treated differently. However, when SB 3 (Stats. 1993, Ch. 31) combined former Revenue and Taxation Code Sections 18451 and 25432, the exemption clause contained in the prior PIT law was inadvertently made applicable to all taxpayers.

The date that each adjustment or resolution resulting from an IRS examination is assessed pursuant to IRC Section 6203 is a fixed date that can easily be determined by both the taxpayer and the department. Using this date for the final federal determination date would clarify when the statute of limitations begins and ends.

The statute of limitation would be the same regardless of how the department receives the federal information.

Implementation Considerations

This bill would reduce disputes between taxpayers and the department by defining the final federal determination date. Taxpayers can easily identify the date since the taxpayer receives an assessment, refund or “no change” report once the adjustment or resolution is assessed pursuant to IRC Section 6203 (commonly known as the “23C date”). The department can identify this date by checking for corresponding entries on the Internal Revenue Service Master File. Taxpayers and the department can verify the date by requesting a copy of Form 23C (or its equivalent) from the IRS.

This bill also would reduce disputes between taxpayers and the department by clarifying current law.

This bill would reinstate the provisions of the B&CT Law (Part 11) that existed prior to the creation of the AFITL, providing department staff with the information necessary to verify that income or losses are reported correctly in subsequent years.

Implementation of this bill would occur during the department’s normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

Requiring taxpayers to notify the department of all federal changes (unless exempt under the PIT exclusion) encourages taxpayers to report accurately in subsequent years and also enables department staff to conduct effective examinations of tax returns. To the extent this bill improves compliance and/or the effectiveness of audits, it potentially could generate additional revenue annually. However, no data are available to measure or even suggest an order of magnitude.

ISSUE #6: Commercial Domicile Restriction

EFFECTIVE DATE

Specific language in this bill would apply the amendments to Section 24410 to all income years in which the statute of limitations remains open.

BACKGROUND

Insurance companies in California are taxed by levying a flat percentage tax (2.35%) on their gross written premiums, with certain deductions. This tax is imposed under Article XIII, Section 28 of the California Constitution and is intended to be "in lieu of" all other taxes or methods of taxation. Thus, a corporation engaged in the insurance business is not subject to the Bank and Corporation Tax Law and is not included in a unitary group's combined report.

Many insurance companies have adopted a corporate structure in which the parent corporation (which is subject to the Bank and Corporation Tax Law) is a holding company with an insurance company subsidiary. One advantage of this structure is that the parent holding company can borrow and invest where the insurance company subsidiary is prohibited for regulatory reasons.

To prevent double taxation (gross premiums tax on the insurance company subsidiary and taxable dividends to the corporate parent), a dividend exclusion was enacted in the Bank and Corporation Tax Law.

SPECIFIC FINDINGS

Federal law allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership); 80% of the deduction is allowed when received from a corporation which is 20% or more, but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of the recipient corporation's recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividend received deduction, capital loss carryback and certain special deductions are not allowed.
Current Bank and Corporation Tax Law provides for the use of an apportionment formula when assigning *business* income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income. Each factor is the ratio of in-state activity to worldwide activity. *Nonbusiness* income is generally allocated to the taxpayer's commercial domicile.

California Regulation Section 25120(c)(4) applies transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends will also be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose which furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials (<u>Appeal of Standard Oil Company of California</u>, Cal. St. Bd. of Equal., 3/2/83).

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities. **The B&CTL** (Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

The B&CTL (Section 24402) excludes from taxable income a portion of dividends received in taxable years beginning after 1989 that are paid out of income that was subject to either the franchise tax, the alternative minimum tax or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporation income at the corporate level. The exclusion is in the form of a deduction from gross income. For the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. The deduction is further limited based on the recipient's percentage ownership in the distributing corporation, similar to the federal stock ownership rules.

Under the B&CTL (Section 24410), corporations *commercially domiciled in California* are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula.

The rationale for Section 24410 is to provide a similar relief from double taxation as is provided to general corporations under the dividends received deduction of Section 24402. Section 24410 essentially determines the hypothetical income that would have been properly imposed on an insurance company if it were in fact subject to the franchise tax, and treats the gross premiums tax as having been imposed on that income.

When Section 24410 was enacted (Stats. 1968, Ch. 1379), essentially all dividends were thought to be nonbusiness income unless receipt of dividends was the taxpayer's principal trade or business (i.e., dealers in stocks and securities). This theory was based on pre-Uniform Division of Income for Tax Purposes Act (UDITPA) case law that held the source of the dividend income was the shares of stock and the situs of such stock was traditionally the commercial domicile of the investing corporation (<u>Southern Pacific Co. v. McColgan</u>, 68 Cal. App. 2d 48 (1945)). Earlier versions of California regulation Section 25120(c)(4) reflected this theory.

Subsequently, California case law held that dividends could be business income if the dividends met the transactional/functional tests implicit in Section 25120, and that the (former) FTB regulations were invalid because they were contrary to those statutory tests (Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., March 2, 1983). The Franchise Tax Board amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as business or nonbusiness income.

Because dividends can be treated as business income, the commercial domicile restriction in Section 24410 operates as a preferential treatment only for California commercially domiciled corporations. Recent court decisions have found similar laws to be unconstitutional as a discrimination against interstate commerce as facially discriminatory, and without legitimate local purpose (e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine [1997] 520 U.S. ____, 137 L. Ed. 2d 852). Thus, it is likely that Section 24410 would be found unconstitutional as discriminatory against interstate commerce.

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power to declare a statute unenforceable, or refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

This provision would remove the commercial domicile restriction from Section 24410. Thus, all corporations, regardless of where commercially domiciled, would be permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax.

In addition, **this provision** makes minor technical changes to R&TC Section 24410.

Policy Considerations

There does not appear to be specific tax policy to support relief from double corporate taxation only for California domiciled holders of insurance stock. Further, the objective of Section 24410 appears to be the same as the objective of Section 24402: to provide relief from double taxation. The commercial domicile restriction of Section 24410 was probably included because, at the time of enactment, such dividends were generally thought to be nonbusiness income, allocated to commercial domicile. By removing the commercial domicile restriction from Section 24410, this bill would make the tax policy of Section 24410 consistent with Section 24402.

Implementation Considerations

If the commercial domicile restriction in Section 24410 is not removed from California law, the department is required by the state's Constitution to enforce the restriction until an appellate court declares California law to be in violation of federal law.

Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this provision would be determined by the amount of insurance dividends (from insurance subsidiaries operating in California) deducted by recipient corporations domiciled outside California, the average apportionment factor of each recipient, and the franchise tax rate.

The provision would result in annual revenue losses that cannot be quantified. Sufficient data do not exist to estimate the magnitude of losses. Even without the provision, revenue losses are likely as the result of cases testing the constitutionality of the current statute under which only commercially domiciled corporations are allowed the deduction.

It is assumed the provision would be enacted after June 30, 1998, and effective for all years in which the statute of limitations remains open. For issues of this sort, generally it is assumed the statute would be open for roughly six income years.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.